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Report on the New Rules for the Operation of Debt-Equity Swaps in Mexico**

Mexico reopened the possibility of executing debt-equity swaps after suspending their operation for over two years.[1] The new Debt-Equity Swaps Rules (Programa de Intercambio de Deuda Pública por Capital; the Rules) were published in the Federal Official Gazette of March 30, 1990.[2]

The Mexican Government issued the Rules as a result of the Foreign Debt Restructuring Agreement (the Agreement) executed with the major international creditor banks on February 4, 1990.[3] The Agreement made possible the allocation of resources in infrastructure projects that would have otherwise been used to service the Mexican debt. The Rules expressly refer to the Agreement as the origin of their creation and state the different methods by which to cancel Mexican debt through the exercise of swap rights.

The Mexican Government made it clear that the purpose of the new procedure regulated by the Rules is the promotion of domestic and foreign investment in accordance with the Agreement and the economic recovery plan.[4] Mexico is

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1. Swaps in Mexico were suspended as a result of the economic recovery plan (*Programa de Estabilidad y Crecimiento Economía* instituted in late 1987. The swaps were considered to have negative side-effects, mainly a higher inflation rate due to the excess of cash flowing into the economy. This was caused by having no limit set for the amount of resources to be channeled through swap agreements.

2. *Programa de Intercambio de Deuda Pública por Capital* (Debt-Equity Swap Rules), *reprinted in* Fed. Official Gazette, Mar. 30, 1990 [hereinafter the Rules]. The Rules provided for a $3.5 billion limit or debt to be cancelled through this procedure. With immediate response, that limit was reached in only two auction calls. New calls will only be issued once new debt swap amounts are authorized.

3. Rohter, *Pact is Signed to Cut Mexico's Debt*, N.Y. Times, Feb. 5, 1990, at B1.

4. This program has been extended until the end of 1991. *See* Wall St. J., Nov. 13, 1990, at A18.

aware that swaps can create benefits by reducing its foreign debt while allocating resources for productive investments in the country. However, swaps cannot be used excessively due to their negative side effects.[5] The Rules create a simpler procedure for authorizing swaps, and promise to be an important tool in attracting investments and accelerating the Mexican economic recovery.[6]

I. The New Rules

A. General Operation

The Rules adopt a mechanism based on an auction procedure. Differing from previous methods, this new scheme allows the Mexican Government to choose among different discount rates offered by the bidders interested in executing swaps. In the past Mexico offered a single discount rate to which the investors had to adhere. Thus, the Rules offer a more flexible and just form of determining not only the discount rate, but also who among the bidders will be awarded the requested swap rights.[7]

B. The Auction Procedure

1. *Requirements to Participate*

Generally speaking no special limitations exist on individuals or legal entities (Mexican or foreign) participating in the auction procedure.[8] A party interested in securing an authorization to execute a swap must submit an application pursuant to the corresponding call issued by the Ministry of Finance and Public Credit (Secretaría de Hacienda y Crédito Público; the Ministry).[9] The application must state the general data of the bidder, the amount of dollars the bidder is interested in channeling through the swap mechanism, and the offered discount rate.[10]

Each party may submit more than one bid if more than one type of debt is to be cancelled. In this sense, the Agreement provides for the existence of four types

5. *See supra* note 1. As mentioned, some limitations have been made to avoid a shocking increase in the inflation rate. *See infra* text accompanying section I.B.2.

6. This has been the case in other Latin American countries, particularly Chile. In fact the Rules greatly resemble the provisions of the corresponding Chilean statute. The Rules, *supra* note 2. Chile has had amazing success with its debt-equity swaps procedure, and has managed to keep the negative inflationary consequences to a minimum.

7. Basically, the idea is to obtain a single discount rate based on the market conditions, the economic situation, and the different rates offered by the bidders. Thus, the bidder offering the highest rate will have a better chance of obtaining a swap authorization and usually at a lower rate than offered to obtain the swap authorization.

8. Due to certain complexities in the process and to comply with a number of formalities, it is recommended (though not compulsory) for applicants to secure legal advice from a Mexican bank or a law firm, or both.

9. Calls pursuant to the Rules are published in the Fed. Official Gazette. The Rules, *supra* note 2.

10. According to the first call, the amounts should be multiples of U.S. $250,000. The discount rate refers to the percentage that the Mexican Government will deduct from the result of converting the debt amount in U.S. dollars to local currency. One should remember that the Mexican foreign debt is sold in the international market for less than its face value.

of debt:[11] (1) discount bonds; (2) par bonds; (3) new resources basis; and (4) new resources. These four types are denominated as convertible debts, and are thus eligible for the swap mechanism. Pursuant to the Agreement, each type has its own peculiarities of operation: different discount rates, cancelling requirements, and amount limitations. The Rules expressly state that the minimum discount rate is 0 percent for debt type number one and 35 percent for the other three.[12] Hence, each applicant is free to submit more than one bid, but naturally only one per type of debt.

2. *Limitations*

As mentioned earlier, Mexico does not want to endanger the achievements of its program to fight the excessive inflation rates that reached their peak in 1987.[13] Therefore, the Rules include measures that prevent swaps from becoming counterproductive devices. These limitations are built into the provisions in two ways: (1) by limiting the amount of foreign currency eligible for conversion through swaps; and (2) by restricting the investment purposes for which swaps may be used.

The Rules set a maximum limit of U.S. $3,500 million that can be channeled through the swap mechanism. By doing so, they are implicitly restricting the amount of local soft currency that can be issued by the Mexican Government to cover the cancelled debt. The authorized amount has already been used through two auction calls issued by the Ministry.[14] Thus, further calls are to be expected only when new debt amounts are authorized to be swapped. Those new amounts and auction calls, in general, do not follow a strict schedule, but rather depend entirely on the economic reports and advice prepared by the Bank of Mexico.[15] Furthermore, additional swaps could only be authorized through another set of Rules or an amendment to the existing ones.

The second limitation involves the purpose of the investment made with the resources obtained through swaps. The Rules set forth only two possible uses: (1) the acquisition of state-owned enterprises (or assets) put up for sale; and (2) financing the purchase of Mexican materials and elements in an eligible infrastructure project.[16]

The Rules allow investors to acquire the mentioned companies[17] using swaps

11. These terms are defined by the introductory part of the Rules and more precisely by the Agreement.

12. Fed. Official Gazette, Mar. 30, 1990, at 6.

13. *See supra* note 1.

14. *See* the Rules, *supra* note 2.

15. Officials of the Ministry informed this author that the idea is to learn about the first two auctions' impact and consequences before authorizing new debt for further calls.

16. An infrastructure project is considered eligible if the federal ministry in charge of the area involved issues a recommendation indicating it is eligible. For example, a highway construction infrastructure project would have to be approved by the Ministry of Communications and Transports.

17. State-owned enterprises have been sold by the Mexican Government since approximately 1982. This is a result of the economic recovery plan and a world trend toward restricting the

up to a maximum of 50 percent of the sale price.[18] For example, a state-owned company is usually sold in cash, or partially through a swap up to half of its price. However, this percentage can be modified if the conditions for the sale of a government-owned entity expressly so state.[19]

Infrastructure projects are also eligible for financing through the swap mechanism, provided two requirements are met: (1) only Mexican elements of the project are eligible;[20] and (2) the project has to be approved by the government agency in charge of the corresponding field of activity.[21] This approval can be obtained prior to or after the auction.[22] However, securing the approval of the project prior to the auction is advisable in order to avoid having a swap authorized for an amount higher than the cost of the project and thus risking loss of the unused proportionate amount of the deposit made pursuant to section 14 of the Rules.[23]

3. *Awarding of Winning Bids*

To participate in the auction for which a call has been made, bids have to be submitted at least four days before the auction date.[24] An option exists allowing the submission of bids in New York rather than in Mexico City, in which case the term is shortened to six days before the auction date.[25] Bids are to be submitted in sealed envelopes containing the official forms provided by the Ministry. The envelopes should be marked on the outside with the data of the relevant auction, and the envelopes should also contain a cashier's check covering the inscription fee established by the corresponding call.[26] Once a bid is submitted, the corresponding applicant expressly submits itself or its principal to the provisions of the Rules and the relevant call. All bids are considered irrevocable.[27]

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government's economic participation to a minimum level. The privatization of many companies formerly owned by the Mexican Government has provided a great impetus considering the size of the companies involved. Several mining companies, the National Telephone Company, the two major airlines, the government's stake in the Mexican banking system, and other such companies, are good examples of the seriousness and relevance of these sales. A list of state-owned companies currently for sale is available from the Ministry; one should note that this list is constantly being updated.

18. The Rules, *supra* note 2, § 6(a).

19. *See infra* text section II for further detail.

20. This requirement is necessary to avoid cancelling foreign debt while, at the same time, generating further indebtedness by the importation of foreign materials, equipment, and other items. These importations are possible, but not by using swap funds.

21. The Ministry keeps a list of the officials of each of the government agencies in charge of issuing these kinds of authorizations. It is important to notice that if the operation involves the sale of a state-owned industry, it is always the Department of Sale of State-owned Companies of the Ministry that will authorize the use of a swap to finance the purchase.

22. The Rules, *supra* note 2, § 6(b). The same interdepartmental committee that determines the auction's final results reviews the approved projects and issues a final authorization to finance them through the swap agreement.

23. *See infra* text section I.B.3.

24. The Rules, *supra* note 2, § 9.

25. *Id.*

26. The call for the first auction established an inscription fee of U.S. $1,000.

27. The Rules, *supra* note 2, § 10.

The Ministry then opens up the envelopes and analyzes the proposed discount rates at which the offerors are willing to enter into swap agreements. This step involves determining a single discount rate at which all swaps will be executed. To determine the rate, the Ministry studies the market conditions, the economic situation and, evidently, the proposed rates. Once the single rate is set, the applicants that have offered a higher rate will have a preferential right to have their requested amounts authorized, and this process continues with the rest of the offerors until the limit in amount is reached.[28] However, if few or no rates equal to or higher than the single rate are offered, then swaps may not be authorized.

This process encourages applicants to offer higher discount rates without the risk of other offerors securing authorizations at lower rates. Of course no rule exists to foreclose the possibility of allocating swaps at a higher rate than the prevailing one in the banking market or others. Hence, all applicants should determine their bids (discount rate) by considering the actual maximum amount at which the swap operation is safe economically.

Results have to be issued within five days following the auction date. The Interdepartmental Committee, of which the Ministry is a member, determines the final results. The winning bidders are then notified of the results in writing. The results are also published in the major Mexican newspapers and may be published in major foreign newspapers if necessary.[29]

4. *Exercise of Swap Rights*

Once notified of the auction results, the winning bidders must make two different payments to secure the official letter confirming their status as holders of swap rights (Derechos de Intercambio): (1) A security deposit payable in local currency equal to 5 percent of the authorized amount less the discount rate must be paid within ten *working* days following the receipt of written notification. This deposit will be reimbursed proportionately to the effectively used portions of the authorized debt for cancellation.[30] (2) In a term not to exceed thirty *calendar* days following the disclosure of the auction results, the winning bidders must pay the duties for the issue of the corresponding certificate entitling them to exercise the swap rights.[31]

The holder of the corresponding rights must submit the following documents to the Ministry to execute the swap agreement (or agreements if the operation

28. "Seventy-two bids were presented in the second auction, 29 of them were accepted. A single discount rate, 52 percent, was applied. The projects that were approved were in the areas of farming, tourism, communications, transportation and industry." Daily Rep. Latin Am., Oct. 15, 1990, at 15.

29. The Rules, *supra* note 2, § 12.

30. *Id.* § 14. Thus, an unused swap will involve losing the proportionate amount of this deposit. *See supra* text accompanying note 18.

31. These duties are set forth by articles 53, section D, and 72, section XIV, of the Federal Duties Law. For 1990, they are calculated in local currency at a rate of 2.5 pesos per each thousand in local currency of the authorized amount, less the discount rate.

involves more than one project): (1) original of the certificate entitling the holder with the swap rights; (2) official letter issued by the corresponding government agency authorizing the amount and type of project to be financed through the swap agreement;[32] (3) letters issued by the creditor bank or banks and their main representative (Citibank) confirming the data of the debt purchased by the winning bidder and thus to be officially cancelled.

To conform with the terms of the Agreement, the winning bidders must enter into the swap agreement with the Ministry by establishing the terms and conditions of the operation, and specifically the data of the debt to be cancelled. The awarded applicant must *completely* exercise its swap rights within eighteen months after the auction date. Thus, the corresponding agreements should be entered into within that period of time.

Simultaneously with the execution of the swap agreement: (1) the corresponding foreign debt is officially cancelled; and (2) an account is opened in an amount equal to the cancelled debt less the discount rate with the Mexican Federal Treasury. This special account is held in the name of the awarded applicant and entitles its holder to use its resources in the authorized project in a term not to exceed forty-two months from the date the swap agreement is executed.[33] During this term, the outstanding balance will yield compoundable interest every three months at a rate equal to: (1) the free currency exchange rate fluctuation between the Mexican currency and the U.S. dollar; and (2) the LIBOR rate for the three months plus 13/16 percent.[34] The yielded interest must be used to finance the approved project.[35]

The Ministry authorizes each disbursement of the local currency account upon proof that those funds are being used in the approved project. The Ministry gradually orders the reimbursement of the 5 percent deposit referred to above while the account is being depleted. The swap holder is released from all liabilities once the account has been fully depleted and the deposit has been completely reimbursed; however, the documents evidencing that all funds were properly used should be kept for an additional five years.

5. *Assignment of Swap Rights*

While the swap rights are in force,[36] their holders can assign them, free or for payment of consideration, without having to secure any prior authorization.

32. This letter may also be from the Department of Sale of State-owned Companies of the Ministry if the operation involves the sale of a state-owned industry.

33. Failure to do so will result in the issuance of a promissory note by the Mexican Government in favor of the account holder in an amount equal to the outstanding balance. This negotiable instrument will mature at the end of fifteen years and will yield interest payable every six months at the LIBOR rate plus 13/16 percent. *See* the Rules, *supra* note 2, § 13.

34. *Id*

35. All capital gains obtained in the operation are subject to the tax regime set forth by art. 151-A of the Mexican Federal Income Tax Law.

36. Swap rights are in force for a term of eighteen months after the date of the auction. The Rules, *supra* note 2, § 13.

However, the former holder must notify the Ministry of the assignment in writing. Likewise, the new holder must submit a brief to the Ministry stating its commitment to accept all the rights and duties of the assigned swap rights, which include the same terms and conditions as the original authorization.

II. Swaps in the Sale of State-Owned Enterprises

A. General Requirements

As mentioned before, swaps may be used for the purchase of Mexican state-owned enterprises in an amount not exceeding 50 percent of their price, unless otherwise specified in their conditions for sale. The purchase of these companies follows the same requirements of any operation financed through a swap agreement. However, the limitation on the amount usable to finance the purchase, mentioned earlier, and the requirement that authorization be obtained from the Department of Sale of State-owned Companies of the Ministry is of special relevance in this case.

B. Procedure

The privatization of the Mexican economy is an ongoing process that has reached the most important government-owned enterprises. Only those companies that are considered essential to the safety or well-being of the nation will escape the process.

Once a decision has been reached to sell a state-owned company, the Department of the Ministry is in charge of handling and supervising the procedure, which ends with the execution of the final purchase agreement.[37] A Mexican bank is designated by the Ministry to act as its agent in the sale of the corresponding company.

The appointed bank issues a call announcing the sale of the company. All interested bidders are then granted a specified term in which to make a deposit enabling them to participate in all further steps of the process.[38] Once deposits have been made, the interested parties are given further, more accurate, and more detailed information about the financial and legal status of the enterprise up for sale. After several studies, including a physical visit to the installations and facilities of the company involved, the agent bank proceeds to make an appraisal of its own. This appraisal is used as a reference and benchmark in evaluating the bids.

After the interested parties submit their bids to the corresponding bank, the latter reviews the bids and suggests the best offers for a final decision to be adopted by the Ministry. These bids include not only the proposed price, but also the form of payment, future projects, and investment figures. If the purchase price is to be paid in cash, then no further approval is necessary and the Ministry

37. Companies currently for sale are included in a list periodically updated by the Ministry.
38. This requirement may be waived if interested parties evidence their solvent financial status.

will decide the winning bid.[39] However, if the price is paid in installments, in kind or through the use of a swap agreement, then the Ministry forwards the files to the Interdepartmental Commission of Expenses and Financing. This Commission will make the final decision.[40] In every case it is possible for the Ministry or the Commission to declare that no bid meets the minimum requirements and thus to refrain from selling the state-owned company. If the auction procedure was not successful then a new call will be issued.

The process explained in the preceding paragraphs is handled independently of the procedure to secure the authorization to execute a swap agreement. Albeit, the official letter approving the purchase of the government-owned company is necessary to execute the final swap agreement.[41] In these cases, two different departments of the Ministry handle both procedures.

III. Conclusion

The Rules have established a clear and modern procedure for authorizing investments in Mexico through debt-equity swap agreements. The provisions contained therein reflect the experience of rules previously in effect and the successful statutes of other countries.[42]

State-owned companies are sold as part of the new government policy and the economic recovery strategy. This trend, which acknowledges the erroneous measures taken by past administrations, is a true accomplishment. By releasing companies that do not form part of the essential state functions to private investors, Mexico is correcting earlier mistakes.

Swap agreements are not seen as a panacea, but rather as an important device among all the different sets of tools used vis-à-vis the challenges the country is facing. A careful mixture between the privatization of the Mexican economy and the swap mechanism can prove to be a useful scheme in the very near future. Moreover, swaps are now carefully monitored to avoid the inflationary negative side-effects of the past. Now the key for a successful operation lies in the complete analysis of the first two auctions' results to clear the path for further swap agreements.[43]

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39. Once a bidder is appointed as the winner, the bidder's deposit will be taken as part of the purchase price. All losing parties will have their deposits returned.

40. The reason for this extra step is that the Mexican Government obviously prefers to sell these companies for cash and will only authorize the purchase through a swap agreement if justified by the circumstances.

41. The Rules, *supra* note 2, § 6(6).

42. Chile's statutes are surprisingly similar. This South American nation has implemented a very successful debt-equity swapping mechanism.

43. So far, there is no known time frame of new authorizations issued for new debt amounts to be swapped. It is expected that the program will not end with only the already used U.S. $3.5 billion.